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Determinants of Host Country for the Financial Subsidiaries of Portuguese Companies

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## **Abstract**

This report analyses the different factors which Portuguese companies consider when choosing a host country to locate a subsidiary of a financial nature. Data of Portuguese companies with subsidiaries was used to perform probit and OLS regressions to test significance of a number of variables. A sample of European countries was used to compare different variables.

## **Introduction**

The topic of this thesis was chosen as part of completing an internship at UK Trade & Investment, specifically the Investments Team, which forms part of the British Embassy in Lisbon. Their main activity is to increase the flow of foreign direct investment to the UK by finding and supporting Portuguese companies who wish to internationalise to the UK..

Foreign Direct Investment (FDI) is “an activity in which an investor in one country obtains a lasting interest, and a significant influence on the management of, an entity in another country”.<sup>i</sup> This activity can be measured in financial investment flows and stocks or ‘real’ activity of foreign affiliates in host countries.

A significant factor in the choice of this topic, is that the Investment team’s key performance indicators are based on the number of new FDI projects which they support in their move to the UK in a financial year and not the overall value of investment flows as mentioned above.

For this reason, the Investment team decided to focus on analysing the competitive advantages of setting up operational holdings, of a financial nature, for Portuguese companies in the UK. This objective is aligned with the wider objectives of UKTI HQ which has recently set up a new team fully dedicated to attracting EHQs to set up in the UK.

The natural assumption is that financial holdings are based in those countries with the lowest corporate taxation rate in order to reduce costs. However, the literature review below demonstrates that this is not true and this thesis will attempt to answer the question of what other factors Portuguese companies consider when choosing a location for their financial holdings.

## **Literature Review**

“Tax policies are obviously capable of affecting the volume and location of FDI, since, [...] higher tax rates reduce after-tax returns, thereby reducing incentives to commit investment funds”.<sup>ii</sup> Studies have shown that a 1% increase in effective tax resulting in approximately 3% decrease in the probability of investing in that country.<sup>iii</sup> However, this is not true when reversed as FDI does not increase in the same proportion when effective tax rate is lowered. Ireland is further proof of this as it has a tax rate which is drastically lower than many other countries and yet, does not attract the largest FDI.

Further to the question of tax, is that of stability. Investors want to feel secure in the future of their investment and of the ‘deal’ which they have entered into. It is no use offering a low tax rate if the investor has no faith that it will remain so.<sup>iv</sup> Stability is also necessary when considering the political and economic nature of the destination country. This seems impossible in the current economic climate, and much worse in countries such as Portugal and Spain. However, there have also been cases of FDI flows having decreased in countries with very stable histories too as a result of the actions of regulatory authorities (such as the radical restructuring of some banking industries) triggering divestment in certain countries.

The United Kingdom, ranked 33 out of 165 on the Political Stability Index<sup>v</sup>, is currently the preferred destination in Europe for foreign direct investment (FDI) with a probability of a project being based there at 22,6% according to the Office of Strategy and Studies at the

Ministry of Economics.<sup>vi</sup> However, this does not remain true for FDI in the form of holdings and other non-productive investments. In these cases, Holland, 21 out of 165, is favoured for investment funds and Luxembourg, 11 out of 165, for SGPS'. Ultimately, these countries are all in the top 20% of the world for stability.

Labour costs seem to offset the negative impact of instability as we see a large increase in FDI in developing countries which tend to be less politically stable. In 2010, for the first time, developing countries absorbed more than half of global FDI.<sup>vii</sup> Sethi et al (Sethi et al, 2003) proposed that increased competition in a host country causes companies to seek efficiency by investing in countries with low wages, namely developing countries, to reduce costs.<sup>viii</sup>

This issue is counter-balanced by proximity factors which are indicated by the fact that a large amount of FDI in the OECD area takes place between those countries with regional trade agreements and geographical proximity. This factor seems to have a reciprocal, yet complex, influence with an increase in foreign trade. The Gravity Model attempts to explain how location of origin (supply) and destination (demand) of trade along with certain characteristics of the individual responsible for the transfer determine the distribution of economic flows.<sup>ix</sup>

Also considered in the Gravity Model are size and growth of the economy as these would for the market for the business. Although, Spain is a case against this because the probability of investment is 4,5% in comparison to Portugal's 1,3% however the economy of Spain is six times the size of Portugal's . Linked to this, are the leading sectors in a particular country as yet another decision factor. For example, the UK has made a strong statement in the creation of Tech City as a destination for all technological companies and investors while

Luxembourg has a highly developed financial sector with a network of additional services for this sector.<sup>x</sup>

A further factor which rounds back to fiscal issues is that of the existence of Double Taxation Agreements (DTA) between the investing country and one of potential investment. These agreements protect investors from being taxed in both countries and give various forms of relief. Hamada (1996) and Musgrave (1969) found that exemption schemes specifically “enhanced FDI outflows to low-tax countries, because repatriated profits are then exempted from taxation”.<sup>xi</sup> However, Talamo warns that this should be done cautiously as removing restrictions can have harmful consequences for the economy of the host country.<sup>xii</sup>

Thus it is possible to see that previous literature confirms that the corporate income tax rate of a country is not the only relevant factor for companies when choosing a location in which to invest.

### **The Nature of Portuguese Culture from an Investment Perspective**

It is important to consider the nature of Portuguese people when analysing the variables which they would consider important when choosing to locate a financial subsidiary outside of Portugal. The attributes which they value as a culture would play a large part in this and thus, it is important to create a mental image of them.

The following variables were created and studied by Emeritus Professor Geert Hofstede whose work in values in workplace culture resulted in the study of each country’s nature. He calls culture the “collective programming of the mind distinguishing the members of one group or category of people from another”.<sup>xiii</sup> He has studied how values in the workplace are affected by culture and this has resulted in five dimensions which can be compared between countries.<sup>xiv</sup>

Portugal's score of 63 reflects that hierarchical distance is accepted and the more powerful the position, the more privileges it holds. The communication between 'boss' and 'employee' is not entirely open and it can be difficult to convey negative information. Portuguese employees would expect that the boss be shown utmost respect and would find it offensive to address him/her in an informal way.

Portugal (along with Spain) is not Individualist at all and their score of 27 indicates a Collectivist society. Emphasis is placed on responsibility and loyalty to the 'group' which includes family, extended family and extended relationships. A person's reputation and behaviour carries much weight in the community and this includes a moral responsibility towards work colleagues. Business deals often result from the use of one's network and connections to other people within one's community.

Linked to its Collectivist nature, is Portugal's low Masculinity score of 31 where polarization is not well considered nor is excessive competitiveness appreciated. Their focus is more on 'working in order to live' and consensus is important. Well-being is a concern and incentives are often free time or flexibility.

Portugal is clearly uncomfortable with uncertainty with a score of 104. This indicates that it has very rigid codes of behaviour and is intolerant of unorthodox behaviour. Rules have great importance and value is placed on hard work, punctuality and security. Innovation may be resisted. There is a great need for security.

These values are confirmed by its score of 30 for the final dimension indicating that it has a short term orientation culture. This emphasises traditions and social pressure with an impatience for results and a small propensity to save. It should be said though, that most Western societies have a short term orientation.<sup>xv</sup>

Based on the above scores, we would expect Portuguese companies to be quite conservative when choosing a host country for their financial subsidiaries. This is as a result of their strong risk aversion but also due to the value that they place on more traditional work environments where the boss is clearly above his/her employees and innovation is not easily accepted. Formality and punctuality are appreciated.

The expectation would be that the factors which are important to a Portuguese company when choosing a location for a financial subsidiary would be strongly linked to these values.

### **Method for Measuring Decision-making Factors**

#### **i. Data**

Data for companies and the location of their subsidiaries was taken from the SABI database available at Nova SBE's library. This is a database of approximately 455 000 Portuguese companies with a variety of information available on them: financial, workforce, location, activities.

Search requirements for the companies were as follows:

- » Portuguese companies
- » Which have subsidiaries that are companies of a financial nature
- » Which are based in a given (foreign) country where the Portuguese company is the Global Ultimate Owner.

This wording was chosen specifically to ensure that we were considering Portuguese companies whose main base and ownership was in Portugal. This group was filtered to only include those that had subsidiaries of a financial nature in Europe. Thus, the data served to show what variables Portuguese companies consider when opening a subsidiary of a financial nature in another host country in Europe.

Comparison countries which did not have subsidiaries were chosen based on their membership of the European Union and European Economic Community with the criterion of having all the necessary data available. The only country which did not meet this criterion was Iceland.

## ii. Interviews

Interviews were conducted with two lawyers who had had experience with transactions of this nature to gain a better understanding of the process and advice on what variables would be most relevant to the transaction.

Mr Tiago Correia Moreira of Vieira de Almeida e Associados has advised those foreign companies who have opened subsidiaries in Portugal. Although this is the contrary situation to the subject of this thesis, the decision-making variables would be very similar and the conversation was valuable. The interview was conducted telephonically and Mr Moreira felt that there were four major issues that were considered by any company when deciding where to locate a subsidiary.

These factors were: a) the opening costs of establishing a company in the host country, b) fiscal issues with regard to specific corporate tax rates, c) regulatory obligations for their specific sector and d) political stability of the country, particularly in the case of developing countries.

The second interview was conducted with Mr Rui Camacho Palma of Linklaters on 6 November 2012 at the Linklaters office in Lisbon. He has worked in both the UK and Portugal and thus, had interesting perspectives for both sides. The interview was extensive and covered two spheres; the first were the reasons (advantages and disadvantages) for



entering the UK market specifically which were based around the flexibility that the UK law gives in certain choices when establishing a company there.

Secondly, general considerations for companies when choosing a location for a financial subsidiary were discussed. The considerations are more relevant to this thesis and were: a) fiscal stability, b) ethical reputation of the country (corruption) and c) language.

### iii. Model and Variables

The following model represents how the flow of FDI between a home country and a host country is based on relevant factors of both countries. Thus, the regressions performed answer how the choice of host country for a subsidiary of a financial nature is dependent on relevant variables in the home and host countries. The actual variables which were chosen are discussed in greater detail below.

$$X_{ij} = Y_i Y_j$$

where:

- $X_{ij}$  represents the flows between the home country  $i$  and the host country  $j$
- $Y_i$  and  $Y_j$  are the relevant factors of countries  $(i,j)$  which are listed below

The following variables were chosen based on previous studies of a similar nature and the advice of the lawyers, Mr Moreira and Mr Palma. They are a mixture of traditional determinants of FDI such as corporate income tax rates and common language and other factors existing in the country of the subsidiary which may be stretching the traditional ambit of this type of study but nevertheless, could affect the decision-making process of the Portuguese company.

1. Fiscal Stability: This value indicates how stable the corporate income tax rate is in a subsidiary location. This is important as parent companies want to be able to trust that their reasoning behind the decision will still be valid in the future and that they will not have to contend with new corporate income tax rates every year. This value was calculated as the variance on the corporate income tax rate per country over varying time periods in the last fifteen years from 1997 to 2011. The higher the variance, the more the country had indeed been changing its corporate income tax rates while a zero variance indicated complete stability in the corporate income tax rate. In this case, the variance was a result of countries lowering their corporate income tax rates as none raised it during this time. These values were taken from the Worldbank database<sup>xvi</sup>. {var15ect, var10ect, var5ect, var510, var1015, var010}

*Hypothesis 1: Variance on the corporate income tax rate will have a negative relationship with the likelihood of locating in a specific country.*

2. Double Taxation Agreement: This value is a dummy of 1 if a DTA exists between Portugal and that country, and 0 if no DTA exists between the two countries<sup>xvii</sup>. This is relevant because DTAs are bilateral agreements with other jurisdictions which allow the company to avoid being taxed both in the host country and in the country of origin by agreeing on special tax rates or credit in the country of origin for the value of corporate income tax rate paid in the host country. These rates are particularly relevant for capital gains and dividend income. They also serve to prevent tax evasion or exploitation of differing tax systems. {dta}

*Hypothesis 2: Existence of a DTA will have a positive relationship with the likelihood of locating in a specific country.*

3. GDP per capita: This variable is an indicator of the total output of a country by considering its gross domestic product and the number of people in that country. This is an indicator of the economic strength of a country. The average of this variable was considered with varying time frames over the fifteen years between 1997 and 2011. These values were taken from the Worldbank's statistics on countries<sup>xviii</sup>. {ave15, ave10, ave5, ave1015, ave510, ave010}

*Hypothesis 3: Average GDP per capita will have a positive relationship with the likelihood of locating in a specific country.*

4. Corruption: This is an index value from Corruption Perception Index 2011 by Transparency International which ranks countries/territories based on how corrupt they are perceived to be. The index value was taken directly from the index with a value of 0 indicating no perceived corruption and the higher the value, indicating an increased level of perceived corruption. {corruption}

*Hypothesis 4: Perceived corruption will have a negative relationship with the likelihood of locating in a specific country.*

5. Economic Risk: This is an index value that shows the level of economic distress that the country is in. This variable is important to consider as it is often associated with political instability as is demonstrated by the fact that most countries which had had an outbreak of instability, had had a decline in GDP in the previous two years<sup>xix</sup>. {econrisk}

*Hypothesis 5: Economic risk will have a negative relationship with the likelihood of locating in a specific country.*

The following variables are based on the cultural dimensions of a country and describe the nature of the citizens of a country. These values have been included to determine whether companies are influenced by the similarity and/or aspiration to have the qualities of another country. The number attributed to a certain dimension only has value when compared to other countries is represented as an absolute value and also as a difference between that country's value and Portugal's value.

6. Power distance: Value which indicates the “degree to which less powerful members of a society accept that power is distributed unequally”. This results in a very hierarchical work structure with less justification of actions. {pdi, difpdi}

*Hypothesis 6: Power distance will have a positive relationship with the likelihood of locating in a specific country.*

7. Individualism: This is a loosely knit society which focuses on having responsibility for yourself and immediate family only as opposed to collectivist societies which feel a responsibility to the ‘group’ and expect that loyalty in return. This society values the achievements of the individual instead of attributing them to the efforts of the group. {ind, difind}

*Hypothesis 7: Individualism will have a positive relationship with the likelihood of locating in a specific country.*

8. Masculinity: This indicates the preference of a society for heroism and material reward in return for success as opposed to a more feminine society which values cooperation and quality of life more. {mas, difmas}

*Hypothesis 8: Masculinity will have a positive relationship with the likelihood of locating in a specific country.*

9. Uncertainty Avoidance: This variable indicates the degree to which members of a society feel uncomfortable with ambiguity or uncertainty. In general, countries with high uncertainty avoidance do not deal well with the fact that the future is always uncertain and often hold onto rigid codes of behaviour and beliefs. They are often intolerant of people or cultures different than them. {uav, difuav}

*Hypothesis 9: Uncertainty avoidance will have a positive relationship with the likelihood of locating in a specific country.*

10. Long term Orientation: This value can be interpreted as a society's attitude towards finding the truth. Those with a short-term orientation are focused on tradition and expect quick results with the 'absolute Truth' being established. Those societies with a long term orientation are more flexible and realise that change is both necessary and inevitable and thus, are more accepting of the idea that truth is based on situation and context. {lto, diflto}

*Hypothesis 10: Long term orientation will have a negative relationship with the likelihood of locating in a specific country.*

### **Limitations of the Data**

As in any study, there are limitations to the data that was available on Portuguese companies which had financial subsidiaries in other European countries. The database itself was bought in 2008 and updates were not complete.

Further to this, the lack of a date of establishment for the subsidiaries in the database also made it difficult to match the correct time of the variable to each subsidiary. It is for this reason that both the corporate income tax rate and average of the GDP per capita over a

certain time period had to be used. Using these measures, ensured that all the possibilities for the time period were considered.

This was also necessary because FDI is considered to be a lagging indicator of the investment environment.<sup>xx</sup> This is because investment flows in a particular year represent decisions and actions taken in months and years prior to that. This is because planning and funds take time to happen before the investment becomes a reality. Thus, FDI reflects the state of the investment environment previous to the year in which it actually happened.

## **Results & Discussion**

The following regressions demonstrate two possible options for the decision-making process and the results show that different variables are found to be significant depending on the perspective of the Portuguese company.

### **A. PROBIT: Binary outcome of locate/not locate for Portuguese companies with subsidiaries in European countries**

The first, a probit regression, demonstrates the variables considered when deciding whether or not to locate a subsidiary in a foreign country. This considers all European countries and has the perspective of a Portuguese company considering the establishment of a new financial subsidiary anywhere in Europe. The variables are those that the Portuguese company would consider from a 'neutral' perspective; that is, considering any European country regardless of whether there were already subsidiaries located there or not.

Figure 1: Stata Probit Regression Results

	a	b	c	d	e
<b>Tax Variance 1997-2006</b>	0.036	0.032	0.034	0.049	0.037
	(2.36)*	(1.90)	(1.96)*	(2.26)*	(2.25)*
<b>Economic Risk</b>	0.584	0.530	0.515	0.719	0.609
	(2.03)*	(1.81)	(1.72)	(2.18)*	(1.80)
<b>Average GDP per capita 1997-2011</b>	0.000	0.000	0.000	0.000	0.000
	(2.07)*	(1.96)	(2.03)*	(2.03)*	(1.95)
<b>Tax Trend 1997-2006</b>		0.048			
		(0.73)			
<b>Masculinity</b>			0.022		
			(1.37)		
<b>Double Taxation Agreement</b>				-1.380	
				(1.13)	
<b>Corruption</b>					0.031
					(0.15)
<b>Constant</b>	-6.167	-7.368	-6.945	-1.380	-6.505
	(2.36)*	(2.28)*	(2.40)*	(1.13)	(1.85)

**var010: The variance of the corporate income tax per country between 1997 and 2006**

There is a positive relationship with variance of the corporate income tax between 1997 and 2006 which says that the greater the variance in corporate income tax in these years was, the more likely a Portuguese company was to locate there. The coefficient for variance of the corporate income tax between 1997 and 2006 is 0.03.

This seems contrary to the belief that fiscal stability is an important factor for companies choosing to locate a subsidiary as stated in *Hypothesis 1*. It is even more surprising considering that Portuguese culture in general has an extremely high uncertainty avoidance score. One would expect that greater variability would in fact have the opposite effect and cause Portuguese companies to be less likely to locate a subsidiary in that host country.

Though, one should consider trends in corporate income tax during this time period. The average variance in corporate income tax was highest in the years between 2007 and 2011 (29,55 compared to 21,93 from 1997 to 2006) as a result of the increasingly competitive nature of corporate income taxes and the general trend of countries lowering their corporate income tax rates to increase inward FDI.

Those countries which had a higher variance of corporate income tax between 1997 and 2006 were those that were likely ‘ahead of the curve’ and had begun dropping their corporate income tax earlier than during the big rush between 2007 and 2011. Countries such as Italy, Netherlands and Poland dropped their corporate income tax rate by as much as 20% during this earlier time period. This drop in corporate income tax rates would have made them more attractive to Portuguese companies wanting to establish a financial subsidiary and explains why the higher variability during this time period, in fact made it more likely that a financial subsidiary be established there.

This idea is similarly confirmed in the Financial Times article of January 2011: “Tax cut fails to woo foreign execs”.<sup>xxi</sup> This article discusses how the lowering of corporate income tax in the United Kingdom has failed to make London a more attractive destination for inward investors. The main reason for this is that there are still jurisdictions such as Ireland, who dropped its corporate income tax rate to 12,5% in 2003, with lower corporate income tax rates. Ireland was clearly ‘ahead of the curve’ in the time period between 1997 and 2006 and



was able to gain an advantage. The Portuguese companies which have taken advantage of this and opened financial subsidiaries in Dublin are Galp, Mota-Engil, Sonaecom, Jerónimo Martins, EDP and Cimpor.<sup>xxii</sup>

The variance of the corporate income tax between 1997 and 2006 is significant at the 5% level. This variable is most strongly affected by the inclusion of the existence of a Double Taxation Agreement in the regression – this increases the coefficient which can be expected as DTA's determine what rate of taxes will be paid in the host country. The masculinity of a country causes a slight drop in the coefficient. This could be that the value of a driven and work-oriented society could compensate for a varying tax rate in the eyes of the investor. Tax trend also drops the value of the coefficient of tax variance but this is likely because they are similar variables.

#### **econrisk: An index value for the economic risk of a country**

The variable for economic risk also has a positive relationship with the likelihood of locating a subsidiary. The coefficient of 0.58 tells us that the higher the economic risk of a country, the more likely that a subsidiary will be located in that country. This seems against rational thinking and, once again, particularly surprising for Portugal who is a country “defined by uncertainty avoidance”.<sup>xxiii</sup> This coefficient seemingly disproves *Hypothesis 5*.

But, one needs to consider that this regression is focussed purely on European countries and thus the economic risk needs to be considered relative to other European countries.

That is to say, Europe has historically been perceived as economically safe (although this has changed in recent years) and thus the general idea of economic risk, should be considered in the context of relativity to other European countries. Netherlands, with an economic risk value of 6, demonstrates this concept because it is traditionally been considered an excellent

destination for holdings companies and is not perceived to be an economically risky country. However, when being compared to countries such as Norway (economic risk value of 2), or Denmark (economic risk value of 4), Netherlands is relatively risky.

Thus, the risk in this case does not equate to choosing a host country with the knowledge that that choice of host country may lead to a loss. It merely reflects that those countries which are attractive locations for financial subsidiaries are relatively more risky than other less attractive locations. However, they are still good destinations for a Portuguese company to locate a financial subsidiary.

The economic risk of a country is significant at the 5% level. It is interesting to note that the inclusion of the corruption variable increases the coefficient of economic risk. This could be because economic risk is a more easily accepted problem than that of corruption. Economic risk is something uncontrollable whereas corruption is a deeper problem of certain societies.

#### **ave15: Average GDP per capita per country from 1997 to 2011**

There is a positive relationship between the likelihood of locating a subsidiary and the average Gross Domestic Product per capita of a country between 1997 and 2011. The positive coefficient of 0.00004 demonstrates that the greater the average GDP per capita from 1997 to 2011, the more likely the location of a subsidiary.

This is logical, and in keeping with *Hypothesis 3*, as the larger the value of all final goods and services produced within a country in a given year (divided by the average population for the same year) the greater the ability of a subsidiary to capitalise on that large market.

This variable is significant at the 5% level. There no change brought to the value of the coefficient by including other variables in the regression.

*Figure 2: Normalised coefficient values for Probit*

<b>PROBIT</b>	<b>Coefficient</b>	<b>Standard Deviation</b>	<b>Normalised Value</b>
var010	0.034	28.54	0.001
econrisk	0.564	1.47	0.38
ave15	0.00004	17582.45	0.0000

These values give us the ability to compare coefficients regardless of the fact that their initial values were different sizes and units. This demonstrates that economic risk in fact is the greatest variable to affect the decision of Portuguese investor when choosing a location for a subsidiary of a financial nature.

The variables which were found to be significant in this probit regression demonstrate the importance of the concept of “soft power” as discussed in a Reuter’s analysis on ‘Confusing hard and soft power in emerging markets’.<sup>xxiv</sup> The article discusses the importance of “soft power” which is described as those intangible characteristics of a country such as culture, social justice and transparency of law. It points out that if FDI was merely based on “raw data such as economic output”, then the gap between established and developing countries would be almost nothing. However, this is not true and Dolan cites the large inequality and lag in “soft power” in developing countries.

This “soft power” is evident in the significance of corporate income tax variance (which indicates stability of fiscal law) and economic risk for Portuguese companies when deciding whether or not to locate a financial subsidiary in a specific country. The mix of GDP per capita as a “hard power” with these two other “soft powers” demonstrates why the traditional

destinations for FDI have maintained their position ahead of the threat of growing developing economies.

B. OLS: Of those European countries with subsidiaries, the likelihood of a Portuguese company locating in a certain country based on the variables discussed above

The second regression goes further, and demonstrates the important variables when considering the countries which have a subsidiary located in them. This regression considers the ‘bandwagon’ effect which is a form of groupthink behaviour that says that conduct or beliefs spread among people (or companies).

Thus, companies will be more attracted to those host countries where they have seen their competitors succeed or where there are already established positive beliefs. This regression compares those countries that have a Portuguese subsidiary located within them and attempts to determine the variables on which these countries need to differentiate themselves.

*Figure 3: Stata OLS Output Table*

. reg number var15ect dta						
Source	SS	df	MS			
Model	4514.54404	2	2257.27202	Number of obs = 26		
Residual	7638.57135	23	332.111798	F( 2, 23) = 6.80		
Total	12153.1154	25	486.124615	Prob > F = 0.0048		
				R-squared = 0.3715		
				Adj R-squared = 0.3168		
				Root MSE = 18.224		
number	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
var15ect	-1.838446	.8418796	-2.18	0.039	-3.580006	-.096885
dta	-45.34724	12.48694	-3.63	0.001	-71.17845	-19.51603
_cons	51.37423	12.49258	4.11	0.000	25.53135	77.21711

The R-squared value indicates the extent to which the variation in the number of subsidiaries located in a host country (y variable) can be attributed to the variance of the corporate income tax rate between 1997 and 2011 and the existence of a Double Taxation Treaty (x variables).

In this case, the R-squared of 0.3715 indicates that 37,15% of the choice of where to locate a financial subsidiary is based on corporate income tax variation and the existence of a DTA.

The value for Adjusted R-squared indicates whether the addition of another variable increases the explanatory power of the model. The closeness of the values of R-squared (37,15%) and Adjusted R-squared (31,68%) indicate that the model is acceptable.

#### **var15ect: Variance in Corporate Income Tax Rate between 1997 and 2011**

There is a negative relationship between the variance in corporate income tax rate over the fifteen year period. This is in line with the advice of Mr Rui Palma of Linklaters who suggested that companies want to be able to trust that the tax rates of a country, when they open a subsidiary, will remain at the same level in the future. This was further confirmed, in the *Público* when discussing the factors outside of corporate income tax rate that were important to investors when choosing a location.<sup>xxv</sup>

Luxembourg is an excellent example of stability and this is evident in their approach towards changing their corporate income tax rates. Except for a drop of 7% in 2002, Luxembourg never adjusted its corporate income tax rate by more than 1% from year to year. This gave an impression of stability because changes were small and investors were never shocked by a huge overhaul of the corporate income tax rate.

The significance of the variance on the corporate income tax rate over the past fifteen years demonstrates that, within the group of countries where Portuguese companies have financial subsidiaries, those with more stable tax rates, have a higher likelihood of having a further Portuguese company subsidiary located there. The coefficient of -1.84 demonstrates that a 1 unit increase in variability of the corporate income tax between 1997 and 2011, results in a

1.84 unit decrease in the likelihood of a Portuguese company locating a subsidiary in that country.

When comparing only those countries that already have subsidiaries located in them, the variable acts as expected in *Hypothesis 1*. It is also interesting to note that in this case, the variability is significant over the full time period between 1997 and 2011. Thus, even taking into account the increasingly competitive nature of corporate income tax rates in recent years, Portuguese companies still value the stability and reliability of a corporate income tax rate.

This variable is significant at the 5% level.

**dta: Existence of Double Taxation Agreement between Portugal and that country (dummy 1;0)**

There is a negative relationship between the existence of a DTA between Portugal and that country which is unexpected.

Personal experience during the internship has demonstrated the importance of the DTA network for each country. The United Kingdom, through the office of HM Revenue and Customs, is continually in negotiations with those countries which they do not yet have a DTA with and feel that it would be a valuable addition to their network. They clearly see value in the existence of a DTA for increasing FDI flows between countries.

This variable is significant at a 1% level.

**Recommendations for UKTI**

The following recommendations have arisen from a combination of advice from Mr Moreira and Mr Palma, results of the regressions and discussions with UKTI.

The stability of the corporate income tax rate is clearly important to Portuguese investors when deciding where to locate a financial subsidiary. The United Kingdom is currently in the process of lowering their tax rate<sup>xxvi</sup> on a yearly basis in order to become more competitive with other jurisdictions such as Ireland. Thus, UKTI needs to make it very clear to Portuguese investors that although these changes are occurring, it is being done for their benefit and they need not be concerned that the form of taxation will remain unpredictable. UKTI could familiarise potential investors with the long-term plan for lowering corporate income tax rates (CIT will be 23% in 2013 and 22% in 2014) so that they know what to expect and see the benefit for them. This should assuage their strong aversion to uncertainty.

The UK is ranked fifth in direct investment in Portugal.<sup>xxvii</sup> This fact could be used to encourage Portuguese investors to feel confident about opening a financial subsidiary in the UK because there are bilateral benefits. The presence of UK companies in Portugal would also benefit Portuguese investors from a networking point. The Collectivist nature of Portugal means that there is value placed on leveraging the network around you which is an obstacle when locating a financial subsidiary in a new country. UKTI could encourage the forming of relationships with those UK companies which are present in Portugal to build the confidence of Portuguese investors when going to the UK.

There is a Double Taxation Treaty in existence between Portugal and the United Kingdom, however the currency difference could cause unpredictable costs with respect to exchange rates<sup>xxviii</sup>. UKTI needs to ensure that Portuguese investors see the pound sterling (£) as a stable alternative to the euro (€) which is currently under much scrutiny due to the economic crisis. In this way, the negative aspect of unpredictable exchange rates is mitigated by the benefit of having profits in a different currency. This attempt to limit the perception of unpredictability also aims to manage the strong cultural value of risk aversion.

A further benefit that UKTI should emphasize is the ease and flexibility of British processes for opening and closing companies. The UK is also open to foreign investment and thus, Portuguese investors would find few bureaucratic obstacles for the opening of their financial subsidiary in the UK.

## **Conclusion**

As we can see, the results discussed above confirm the Expresso article<sup>xxix</sup> that says that lowering tax rates help to capture investment but are not everything. Other factors, besides the corporate income tax rate, were also found to be significant and indicated that the ‘bigger picture’ of a country’s offering is what truly matters to potential investors. This is true for both traditional determinants of FDI and other considerations which have since arisen.

Both regressions demonstrated that the stability of the corporate income tax rate in a country was relevant to the decision-making process of a Portuguese company when deciding on a location for a financial subsidiary. This was found both when the company was deciding whether or not to locate in a specific country and also when comparing those countries which already had financial subsidiaries located in them.

When deciding whether or not to locate in a country, the general position of that country was relevant to the Portuguese investors. The significant variables of economic risk and average GDP per capita are both variables which would indicate the state of a potential host country in general economic terms.

However, the more detailed issues became prominent when comparing those countries which did have a subsidiary located in them. The existence of a Double Taxation agreement was significant which illustrates the competitive nature of attracting inward investment and the need to use every avenue to give the best possible offer to potential investors.



None of the cultural values were found to be significant in either of the regressions. However, when analysing those variables that were significant, it is possible to attribute some of the causes to Portugal's cultural values. For example, the significance of the corporate income tax variability over the past fifteen years could be linked to the strong Portuguese cultural value of uncertainty avoidance. The need for stability over the full fifteen years demonstrates a need to be very certain that the investor could trust that the corporate income tax rate would remain close to what they had agreed to when investing in that country.

Thus, we see that corporate income tax rates are not the only factor which Portuguese companies consider when choosing a destination to open a financial subsidiary.

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- <sup>xii</sup> GMC Talamo "Institution, FDI and the Gravity Model" Università di Palermo p2
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- <sup>xv</sup> <http://geert-hofstede.com/portugal.html> Accessed 13.11.2012 at 12h26.
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- <sup>xvii</sup> <http://www.millenniumbcp.pt/template/print.ihtml?articleID=4089> Accessed on 27.2.2012 at 12h19
- <sup>xviii</sup> <http://data.worldbank.org/indicator/NY.GDP.PCAP.CD> Accessed on 29.10.2012 at 17h22.
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